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SUBJECT: UKRAINE: NAFTOHAZ REFORMS UNLIKELY

¶1. (SBU) Summary. In meetings with Naftohaz Chairman Oleh Dubyna and PM Tymoshenko Energy Advisor Vitaliy Hayduk in late September both stated that the structural reform of the gas sector was unlikely, even unnecessary. Dubyna stated that he would not support the unbundling of Ukraine's gas transit system (GTS), in opposition to promises made to the EU in March. Dubyna told us that Naftohaz already operated successfully and pointed to the state-energy company's performance during the two-week cutoff of Russian gas supplies in January 2009 as evidence that it was able to manage the strategic gas transit system effectively. Hayduk stated that there had been no gas crisis in Ukraine at the beginning of the year and that Ukraine would be ready for any difficulties this winter. He also predicted that gas sector reforms would not move ahead in the current political climate. End summary.

BEARISH ON NAFTOHAZ REFORMS  
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¶2. (SBU) Naftohaz Chairman Oleh Dubyna was clear about his resistance to structural reforms of Naftohaz in a September 23 meeting. He stated that Naftohaz already operates in line with all EU directives and rejected any attempt to "add, subtract, split, or divide" Naftohaz. Dubyna stated that Ukraine had already begun to diversify the natural gas market and pointed to a Cabinet of Ministers' resolution from the spring that allows certain chemical companies to purchase gas directly from Russia. (Note: Although the resolution was passed in April 2009, we have not heard of any chemical companies successfully contracting directly with Russian gas suppliers. End note.) Dubyna also rejected the EU's call to "unbundle" the gas transit system (GTS) from Naftohaz. He stated that Naftohaz had proven that the GTS operates effectively within the Naftohaz structure, pointing to the company's success in reversing the flow of the system for the first time in its history during the January 2009 cutoff. Unbundling the GTS from Naftohaz would have a negative effect.

WAITING FOR DONORS ON GTS MODERNIZATION PROGRAM  
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¶3. (SBU) Despite Dubyna's clear rejection of the basic commitments made by the GOU to the EU, World Bank, EBRD, and EIB at the March 23 Brussels conference on financing for modernization of the gas transit system, Dubyna said that progress on the financing program was held up because the EU and others had not responded to Naftohaz's project proposals, commenting that the Europeans found their holidays "more important" than the GTS project. (Note: In conversations with

the World Bank and the EU, it is clear that they have found working with Naftohaz on the GTS modernization project trying. Dymtro Glazkov, the World Bank's energy expert, told us that the feasibility studies would likely not meet the Bank's requirements. End note.)

"WHO KNOWS WHAT RUSSIA WILL DO"

14. (SBU) Discussing the likelihood of a repeat of the January 2009 gas crisis, Dubyna stated, "Who knows today what Russia will do in the future?" To counter the possibility of a cutoff, Dubyna said that the government decided after the 2009 cutoff to create a strategic reserve of natural gas. Naftohaz has 25 billion cubic meters (bcm) of gas in its storage facilities already this year, versus 11 bcm at the end of 2008. He commented that Naftohaz had not overcome all its difficulties with Russia but believed it would be able to resolve outstanding issues. Dubyna noted that Naftohaz had asked Gazprom to lower the 2010 contracted volumes from 52 bcm to 33.75 bcm by the July 1 deadline in the contract but that Gazprom had yet to respond.

15. (SBU) In a separate conversation on September 24, Vitaliy Hayduk, head of the group of advisors to PM Tymoshenko, rejected that there was a gas crisis for Ukraine in 2009. He said that although Russia had shut off gas supplies, Ukraine did not have problems as it successfully reversed the flow of its gas transit system to supply gas from underground storages in the west to consumers in the east. It would do the same this winter if Russia decided to turn off gas supplies. He noted the problem is for Europe, not Ukraine. Hayduk repeated what Dubyna told us that Ukraine was even better prepared this year, with higher volumes of gas in storage.

16. (SBU) Hayduk also suggested that there would be no reform in Ukraine's energy sector now due to the divide between the Rada (Ukraine's parliament) and the government. He said vested interests would ensure that monopolies were not broken up, pointing out that government ministers in particular would not support changes to the current system that may bring about less profitability to their sector. He thought this was true even if the changes represented progress, a savings to consumers, or development for the economy in general.

17. (SBU) Comment. Dubyna's comments rejecting calls for structural reforms at Naftohaz underline how difficult it will be to achieve meaningful reform in Ukraine's gas sector.

Absent a clear political decision from the Prime Minister, Naftohaz's leadership will not support efforts to divide the bloated and inefficient company into more manageable and financially viable segments. If the EU and IFIs take a hard line on the conditions of the March 23 Brussels declaration, financing for the modernization of Ukraine's GTS will remain a pipedream for some time to come. End comment.

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